United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

76-5020

To be argued by
PHILIP H. CURTIS

United States Court of Appeals
FOR THE SECOND CIRCUIT

B

Docket No. 76-5020

In the Matter
of
F. O. BAROFF COMPANY, INC.,
Debtor.

AMERICAN BANK & TRUST COMPANY,
Plaintiff-Appellant,
—*against*—
EDWARD S. DAVIS, TRUSTEE,
Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR DEFENDANT-APPELLEE

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BRIEF FOR DEFENDANT-APPELLEE

Issues Presented

1. Whether the general estate of an insured debtor, and not a third party, is entitled to reimbursement from the debtor's indemnity insurer for losses actually sustained by the debtor.

2. Whether the New York direct action statute applies where the insured debtor under an indemnity poiicy has suffered losses covered by the insurance policy.

Statute Involved

Section 167 of the Insurance Law of the State of New York (N.Y. Ins. Law § 167 (McKinney's 1966)) provides in pertinent part as follows:

> 1. No policy or contract insuring against liability for injury to person, except as stated in subsection three, or against liability for injury to, or destruction of, property shall be issued or delivered in this state, unless it contains in substance the following provisions or provisions which are equally or more favorable to the insured and to judgment creditors so far as such provisions relate to judgment creditors:
>
> (a) A provision that the insolvency or bankruptcy of the person insured, or the insolvency of his estate, shall not release the insured from the payment of damages for injury sustained or loss occasioned during the life of and within the coverage of such policy or contract.
>
> (b) A provision that in case judgment against the insured or his personal representative in an action brought to recover damages for injury sustained or loss or damage occasioned during the life of the policy or contract, shall remain unsatisfied at the expiration of thirty days from the serving of notice of entry of judgment upon the attorney for the insured, or upon the insured, and upon the insurer, then an action may, except during a stay or limited stay of execution against the insured on such judgment, be maintained against the insurer under the terms of the policy or contract for the amount of such judgment not exceeding the amount of the applicable limit of coverage under such policy or contract.
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> * * *

Statement of the Case

American Bank & Trust Company (the "Bank") is appealing from an order of the United States District Court for the Southern District of New York, Hon. Lawrence W.

Pierce, Jr., dated March 25, 1976, denying the Bank's claim to insurance proceeds recovered by the Trustee ("Trustee") for the liquidation of the business of F.O. Baroff Company, Inc. (the "Debtor" or "Insured") from the Debtor's insurer, Insurance Company of North America ("Insurer"), except to the extent that the proceeds exceeded the amount of insured losses sustained by the Debtor (241a-254a).[1]

The order appealed from affirmed in all respects an order of the Hon. Edward J. Ryan, Bankruptcy Judge, dated June 20, 1975 (228a-229a). The Bankruptcy Judge's order granted the Trustee's motion for summary judgment against a complaint filed by the Bank on June 17, 1974 and amended on October 7, 1974. The Bank by its complaint claimed the $100,000 proceeds of an indemnity insurance policy maintained by the Debtor. The Bankruptcy Court ordered that the Debtor's general estate was entitled to retain $93,691.03 of the $100,000 insurance proceeds (229a). The order was based on the finding that the Debtor had sustained losses in the amount of $93,691.03 (233a) and the conclusion that Section 167 of the New York Insurance Law did not deprive the Debtor of its contractual right to indemnification from its Insurer for losses actually sustained (237a-239a).

Statement of Facts

The Losses Sustained By The Debtor

On January 6, 1972 the Debtor, a securities broker-dealer, was placed in liquidation pursuant to the Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa *et seq.* (232a). At that time the Bank held securities pledged by the Debtor under a security agreement between the two parties (232a). These securities were subsequently sold by the Bank and the proceeds were held in escrow pending a determination of the rights of the respective parties in the proceeds (232a).

1. References to " a" are to the Joint Appendix.

The Bank contended that the "dragnet" clause of its security agreement covered, among other things, certain contingent claims which the Bank asserted against the Debtor as a result of the Bank's potential liability to third parties (232a).[2] The principal such claim resulted from the sale through the Debtor of certain securities stolen from Mrs. Esther Corey ("Corey"). The Bank guaranteed the endorsements on the stolen securities (231a). And it asserted that the Debtor would be liable to it under the security agreement for its potential liability to Corey (233a).

The Trustee initially opposed this position and asserted that the contingent claim was not covered by the security agreement (233a). This issue became moot, however, when the Bank paid Corey $180,449.58 in full settlement of her claim against the Bank for its guarantee of signatures on the stolen securities (233a). Since the Corey claim was no longer contingent, the Trustee agreed to release the remaining escrowed proceeds of the Debtor's pledged securities, $79,321.62, to the Bank (233a).

In addition to the $79,321.62 paid to the Bank, the Debtor suffered other losses of $14,369.41 as the result of sale of the stolen Corey securities through it. In December 1971 the Debtor paid Corey $5,128.54 representing accrued dividends on the stolen securities (231a). Also in December 1971, the Debtor paid Loeb Rhodes & Co. $9,240.87. This amount covered Loeb Rhodes & Co's redelivery of securities to Corey which had been sold by Loeb Rhodes & Co. on behalf of the Debtor (231a).

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2. Not in issue here are payments to the Bank from the escrowed fund of underlying indebtedness in the amount of $107,021.32 plus 52.124% of the profits earned on such amount, $15,000.00 on another claim and legal fees of $16,083.81 (232a).

Thus, the Debtor sustained total losses of $93,691.03[3] as the result of the sale through it of the securities stolen from Corey. Such losses gave rise to a claim against the Debtor's indemnity insurer for reimbursement.

The Insurance Contract

The Debtor on July 9, 1970 obtained an indemnity insurance policy (the "Insurance Policy"), generally referred to as a "Broker's Blanket Bond", from the Insurer (231a). The Insurance Policy obligated the Insurer to reimburse the Debtor up to the $100,000 limit of coverage for losses resulting from, among other things, the lack of integrity, fidelity or honesty of employees, and the sale of forged securities by it (200a, 231a). Under the Insurance Policy, the Insurer's obligation to the Debtor arose when the Debtor had sustained loss, in this case, through payments to injured third parties (237a). The Debtor had paid all premiums due on the Insurance Policy which remained in full force and effect at the commencement of the liquidation (231a).

In December 1971 prior to the commencement of liquidation, the Debtor filed an initial claim under the Insurance Policy for the $14,369.41 which it had paid to Corey and Loeb & Rhodes & Co. (225a, 232a). After the Bank had paid Corey and the Trustee had, consequently, released the remaining escrow to the Bank, the Trustee filed an amended claim for $100,000.00 (232a).[4] That amount was subsequently received and added to the Debtor's general estate (233a).

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3. The aggregate of $79,321.62 paid to the Bank, $5,128.54 paid to Corey and $9,240.87 paid to Loeb Rhodes & Co.

4. Subsequently, the Trustee amended the claim to $93,691.03, the amount of the actual loss sustained by the Debtor, and did not oppose the Bank's claim for the remaining $6,308.97 of the proceeds.

Argument

The Insurance Policy was an indemnity contract which obligated the Insurer to reimburse the Debtor for losses sustained by it. The Debtor had paid all premiums due and the policy was in full force at the time the liquidation commenced. The Debtor sustained insured losses totalling $93,691.03, giving rise to a claim against the Insurer.

A trustee is entitled to recover the proceeds of a debtor's indemnity insurance to cover losses sustained by the debtor. Section 167(1)(b) of the New York Insurance Law does not eliminate this contract right by giving priority to an injured third party. Rather, as held in *Merchants' Mutual Automobile Liability Ins. Co.* v. *Smart*, 267 U.S. 126 (1925), the statute gives a third party a direct right of action on an indemnity policy when the debtor or its trustee is unable to take advantage of the indemnity contract because no loss has been sustained. Since the Debtor here suffered loss by payments to the Bank and other injured third parties, the Trustee is entitled to retain the insurance proceeds for the Debtor's general estate.

I.

The Debtor's General Estate Is Entitled To Reimbursement For Losses Sustained By The Debtor

The Insurance Policy was a typical broker's fidelity bond. It was an indemnity policy which obligated the Insurer to reimburse the Debtor for losses to it arising from, among other things, the lack of integrity, fidelity or honesty of employees, and the sale through it of forged securities. *See American Empire Ins. Co.* v. *Fidelity & Deposit Co. of Maryland*, 408 F.2d 72, 77 (5th Cir.), *cert. denied*, 396 U.S. 818 (1969); *New Amsterdam Casualty Co.*

v. *Waller,* 233 N.C. 536, 64 S.E.2d 826, 827-28 (1951). The Insurance Policy clearly stated that:

> "The Underwriter * * * agrees to indemnify and hold harmless the Insured * * * from and against any losses * * * sustained by the Insured." (199a)

Under an indemnity policy, a claim can be made only after a loss has been actually sustained. A loss occurs not when liability attaches to the insured, but when payment is made to an injured party. *See Harris* v. *Standard Accident & Ins. Co.,* 297 F.2d 627, 630-31 (2d Cir. 1961), *cert. denied,* 369 U.S. 843 (1962); *Ronnau* v. *Caravan Int'l Corp.,* 205 Kan. 154, 468 P.2d 118, 123 (1970). And under a policy insuring against loss as distinguished from a policy insuring against liability, the insurer's obligation runs solely to the insured and not to any other person as a third-party beneficiary. *Hanover Ins. Co.* v. *Tyco Industries, Inc.,* 500 F.2d *supra* at 656; *American Empire Ins. Co.* v. *Fidelity & Deposit Co. of Maryland,* 408 F.2d *supra* at 76-77. The insured Debtor, having paid the premiums to maintain coverage for its loss under the Insurance Policy, was entitled to the benefit of its contract. And, where the Debtor has suffered loss by payments to injured third parties, its general estate is entitled to reimbursement under the contract of indemnity with the Insurer.

The Bank does not contest that the $14,369.41 paid by the Debtor to Corey and Loeb Rhodes & Co. was a loss sustained by the Debtor. Under the provisions of the Insurance Policy, the Debtor's general estate is entitled to reimbursement for that sum.

The Bank, however, contends that the release of $79,312.62 to the Bank from the escrowed sale proceeds of the Debtor's pledged securities was not a loss to the Debtor's general estate (B. Br. 20-21).[5] This contention is bot-

5. References to "B. Br." are to the Brief for Plaintiff-Appellant.

tomed on the claim that the Bank, after payment of its liability to Corey, had an interest in the pledged securities superior to that of the Trustee. However, had the Bank chosen not to exercise its security interest in the $79,321.62,[6] the funds available to the Debtor's general estate would have been increased. Thus, it is clear that the Bank's reliance on its security to cover the Corey claim effected a reduction in the funds available to the Debtor's general estate and resulted in a loss to the general estate. Since the loss resulted from the sale of the Corey securities through the Debtor, the Debtor's general estate was clearly entitled to reimbursement from the Insurer.

II.

The New York Direct Action Statute Does Not Apply Where The Insured Has Suffered Losses Covered By An Indemnity Policy.

A. The Proceeds Of The Debtor's Indemnity Insurance Contract Attributable To Losses Sustained By The Debtor Pass To The Trustee.

A trustee is entitled to recover the proceeds of a debtor's indemnity insurance policy to cover loss sustained by the debtor. Thus, in a case where an injured third party asserted a right to the proceeds of a bankrupt's policy of insurance against loss or theft of property despite the fact that the bankrupt had suffered loss, the United States Court of Appeals for the Third Circuit held:

> "On his appointment, the Trustee was vested with title to all of Parkway's [the bankrupt] property, Bankruptcy Act § 70a, 11 U.S.C. § 110(a) (1970), *including insurance policies and rights of action under them.* See 4 A Collier, Bankruptcy Para. 70.24 (14th ed. 1971) * * *. Not only did the Trustee hold

6. Such a course was clearly available to the Bank. *See United States Nat'l Bank* v. *Chase Nat'l Bank,* 331 U.S. 28, 33-34 (1947).

> title to Parkway's assets; he also was authorized, exclusively, to bring actions that could have been instituted by the bankrupt for the aggregation of assets and for the protection of creditors. 2 Collier Para. 47.05; 4 A *id.* Para. 70.28 [1]. * * *" [Emphasis added.]
>
> *Hanover Ins. Co.* v. *Tyco Industries Inc.*, 500 F.2d 654, 656-57 (3d Cir. 1974).

See also, *In re Podolsky*, 115 F.2d 965, 967 (3d Cir. 1940) (holding a trustee entitled to the proceeds of a bankrupt's fire insurance policy). Moreover, a trustee has been held entitled to insurance proceeds covering losses realized after bankruptcy. *Fuller* v. *New York Fire Ins. Co.*, 184 Mass. 12, 67 N.E. 879 (1903); *Passen* v. *United States Casualty Co.*, 319 Ill. App. 59, 48 N.E.2d 545 (1st Dist. 1943).

The situation is otherwise with respect to liability policies. Unlike the indemnity policy involved here, a liability policy fixes the insurer's obligation when liability attaches to the insured and such obligation may be seen as running to the benefit of third party beneficiaries under the contract. *See, e.g., Harris* v. *Standard Accident Ins. Co.*, 297 F.2d 627, 630-31 (2d Cir. 1961), *cert. denied*, 369 U.S. 843 (1962); *Ronnau* v. *Caravan Int'l Corp.*, 205 Kan. 154, 468 P.2d 118, 122 (1970).

Cases cited by the Bank in support of its contention that the Trustee has no right to indemnity insurance proceeds are in fact cases which expressly apply the rule as to liability policies as distinguished from indemnity policies[7] (B. Br. 15-17). Indeed in *Cissell* v. *Amer. Home Assurance Co.*,

7. *See Cissell* v. *Amer. Home Assurance Co.*, 521 F.2d 790, 792 (6th Cir. 1975), *cert. denied*, —— U.S. —— , 96 S. Ct. 857 (1976); *In re Fay Stocking Co.*, 95 F.2d 961, 962 (6th Cir. 1938); *Fix* v. *Automobile Club Inter-Insurance Exch.*, 413 S.W.2d 194, 197 (Mo. Sup. Ct. 1967); *Fidelity Union Casualty Co.* v. *Hanson*, 26 S.W.2d 395, 400 (Tex. Civ. App. 1930), *aff'd*, 44 S.W.2d 985 (Tex. Comm. App. 1932), *cert. denied*, 287 U.S. 599 (1932).

521 F.2d 790 (6th Cir. 1975), *cert. denied,* ——U.S. ——, 96 S. Ct. 857 (1976), the court, while holding that an injured party had a property right in the bankrupt's liability policy, recognized by its citation of *Hanover Ins. Co.* v. *Tyco Industries, Inc., supra,* that a different rule applies to policies indemnifying the insured against loss:

> "* * * the injured party rather than a trustee in bankruptcy has the beneficial property right in a *liability policy* where the terms of the policy give the injured party a right of action against the insured. In re Fay Stocking Co., 95 F.2d 961 (6th Cir. 1938); *cf. Hanover Insurance Co.* v. *Tyco Industries, Inc.,* 500 F.2d 654 (3d Cir. 1974)." [Emphasis added.]
> 521 F.2d at 792.

B. Section 167 Does Not Alter The Rule As To Indemnity Insurance In The Circumstances Present Here.

The common law doctrine of direct action by an injured party againt a *liability* insurer was subsequently adopted by statute under Section 167 of the New York Insurance Law ("Section 167"), N.Y. Ins. Law §167(1)(b) (McKinney's 1966). Section 167, however, has also been held, in a particular circumstance to apply to indemnity policies. *See, Merchants' Mutual Automobile Liability Ins. Co.* v. *Smart,* 267 U.S. 126 (1925); *Coleman* v. *New Amsterdam Casualty Co.,* 247 N.Y. 271, 160 N.E. 367 (1928); *Skenandoa Rayon Corp.* v. *Halifax Fire Ins. Co.,* 245 App. Div. 279, 281 N.Y.S. 193 (4th Dept.), *aff'd,* 272 N.Y. 457, 3 N.E.2d 867 (1935). Thus, the enactment of Section 167 specifically corrected an inequitable situation that sometimes occurred in bankruptcy with respect to indemnity policies, namely, the *de facto* release of the indemnity where the insured suffered no loss because it had no funds to pay an injured third party. *Coleman* v. *New Amsterdam Casualty Co.,* 247 N.Y. *supra* at 275.

Section 167, however, does not divest the Insured of its contract right to indemnification where loss has in fact been sustained. The direct action provisions of the statute only become operative when, or to the extent that, the insured or its trustee cannot take advantage of the contract because no loss has been suffered. Thus, Section 167 provides in the first instance that insurance contracts must contain provisions:

> "* * * which are equally or more favorable *to the insured* and to judgment creditors so far as such provisions relate to judgment creditors * * *" [Emphasis added.] N.Y. Ins. Law § 167(1) (McKinney's 1966)

and which

> "* * * shall not release the insurer from the payment of damages for injury sustained or loss occasioned during the life of and within the coverage of such policy or contract." N.Y. Ins. Law § 167(1)(a) (McKinney's 1966).

In addition Section 167(1)(b) preserves the indemnity policy in the special situation where no loss is suffered by the insured because of bankruptcy. It does so by providing that an injured third party may proceed directly against the insurer within the applicable limit of coverage under the policy[8] when a judgment against the insured remains unsatisfied after 30 days.[9] Nowhere in Section 167 or in the

8. Where as here $6,308.97 of the policy coverage remained after satisfaction of the Insurer's contract obligation to the Insured, a judgment creditor could assumedly proceed directly against the Insurer for that amount.

9. The Bank's contention that it could have initially recovered the full insurance proceeds and then resorted to its collateral (B. Br. 22) is belied by the statutory scheme. Had the Bank obtained a judgment against the Insured as required by § 167(1)(b) as a precondition to a direct action, the collateral would have been immediately payable to the Bank, thereby giving rise to a loss by the Insured and reducing the amount of insurance coverage available to a third

cases construing it, is it even remotely suggested that this Section deprives an insured of its rights to be indemnified under an indemnity policy where it has in fact suffered a loss.

The cases cited by the Bank do not support the contention that Section 167 permits the Bank to recover the insurance proceeds where the Debtor has actually suffered loss. In all such cases, the insolvent or bankrupt insured had made no payments and suffered no loss. Thus, in *Merchants' Mutual Automobile Liability Ins. Co.* v. *Smart,* 267 U.S. 126 (1925), the Court held that an injured third party could collect in a suit against the insurer under the predecessor provision to Section 167. The Court held:

> "* * * But the clause becomes operative *only* in the event of the insolvency or bankruptcy of the assured *when he can no longer use the indemnity to pay the injured person as he should.* * * *" [Emphasis added.] 267 U.S. at 131.

In that case the insured had sustained no loss and had made no payment to third parties. And the statute was properly invoked, the Court concluding that title to the indemnity had passed to the third party. But here as recognized by the District Court (251a-252a) the Debtor has made payments of $93,691.03 to injured third parties thereby suffering loss. The direct action provisions of the statute do not become effective in such a circumstance.

In each of the other cases cited by the Bank to support its claim that title to the insurance proceeds rests in the injured claimant, the insured party had made no payments and had suffered no loss. As well each of those cases

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party by the amount of the collateral lost by the Insured. Additionally, *Century Ins. Co.* v. *First Nat'l Bank of Hughes Springs, Texas,* 102 F.2d 726 (5th Cir.), *cert. denied.,* 308 U.S. 570 (1939) relied upon by the Bank, does not even remotely support its contention.

involved liability policies as opposed to indemnity policies.[10]

The Bank contends that the District Court's recognition that the Debtor's general estate is entitled to the insurance proceeds somehow results in an inequitable benefit to F. O. Baroff Company, Inc., the Debtor (B. Br. 23, 24-27). Thus, the Bank suggests that the Debtor is now allowed to retain the insurance proceeds, while absent liquidation the Bank would be entitled to such proceeds (B. Br. 23). This assertion is inaccurate both in that it is the general creditors of the Debtor, not the Debtor, who received the insurance proceeds and in that absent liquidation the Bank would have no unique property interest in proceeds of indemnity insurance recovered by the Insured nor would it have any right of action against the Insurer.

The Bank also suggests that the imagined benefit to the Debtor is contrary to policy requiring brokers to obtain insurance policies such as the one in issue here (B. Br. 24-27). Once again, the Bank's assertion is inaccurate both in that general creditors, not the Debtor, received the benefit of the Debtor's insurance and in that the policy requiring such insurance is furthered by the District Court's decision that the general estate of the Debtor should recover for losses sustained by it.

Thus, as the courts below properly held, the direct action provisions of Section 167 have no application to a case where the Debtor has actually sustained loss by payments to injured third parties. And the Bank can make no claim to the insurance proceeds received by the Debtor's general estate in reimbursement for the loss.

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10. *See Cissell* v. *Amer. Home Assurance Co.*, 521 F.2d 790, 792-93 (6th Cir. 1975), *cert. denied*, —U.S.—, 96 S. Ct. 857 (1976); *In re Fay Stocking Co.*, 95 F.2d 961, 962 (6th Cir. 1938); *Fix* v. *Automobile Club Inter-Insurance Exch.*, 413 S.W.2d 194, 197 (Mo. Sup. Ct. 1967); *Fidelity Union Casualty Co.* v. *Hanson*, 26 S.W.2d 395, 400 (Tex. Civ. App. 1930), *aff'd*, 44 S.W.2d 985, (Tex. Comm. App. 1932), *cert. denied*, 287 U.S. 599 (1932).

Conclusion

The District Court's judgment should be in all respects affirmed.

Dated: New York, New York
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